

TORCH ENERGY ROYALTY TRUST  
Form 10-Q  
February 03, 2014

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

**Form 10-Q**

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2013**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 1-12474**

**Torch Energy Royalty Trust**  
**(Exact Name of Registrant as Specified in Its Charter)**

**Delaware**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**74-6411424**  
**(I.R.S. Employer**  
**Identification Number)**

**Rodney Square North**  
**1100 North Market Street, Wilmington, Delaware**  
**(Address of Principal Executive Offices)**  
**302/636-6435**

**19890**  
**(Zip Code)**

**(Registrant's telephone number, including area code)**

**Not Applicable**

**(Former name, former address and former fiscal year, if changed since last report)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☒

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Small reporting company ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of January 27, 2014, 8.6 million Units of Beneficial Interest of the Trust were outstanding.

## **TORCH ENERGY ROYALTY TRUST**

### **PART 1 - FINANCIAL INFORMATION**

#### **Item I. Financial Statements**

This document includes forward looking statements within the meaning of Section 27A of the Securities Act of 1993, as amended, and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical facts included in this document, including without limitation, statements under Discussion and Analysis of Financial Condition and Results of Operations regarding the financial position, reserve quantities and net present values of reserves of the Torch Energy Royalty Trust ( Trust ) and statements that include the words believes , expects , anticipates , intends , estimates , projects , target , goal , plans , objectives , should or similar expressions forward-looking statements. Torch Energy Advisors Incorporated ( Torch ) and the Trust can give no assurances that the assumptions upon which these statements are based will prove to be correct. Factors which could cause such forward looking statements not to be correct include, among others, the cautionary statements set forth in the Trust s Annual Report on Form 10-K with the Securities Exchange Commission for the most recent fiscal year, cautionary statements contained in this report, the volatility of oil and natural gas prices, future production costs, future oil and natural gas production quantities, operating hazards, and environmental conditions.

#### **Introduction**

The financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. The Trust was formed effective October 1, 1993, pursuant to a trust agreement ( Trust Agreement ) among Wilmington Trust Company, not in its individual capacity but solely as trustee of the Trust ( Trustee ), Torch Royalty Company ( TRC ) and Velasco Gas Company, Ltd. ( Velasco ) as owners of certain oil and natural gas properties ( Underlying Properties ) and Torch Energy Advisors Incorporated ( Torch ) as grantor. TRC and Velasco created net profits interests ( Net Profits Interests ) which burden the Underlying Properties and conveyed such interests to Torch. The Trust was formed under the Delaware statutory trust act (formerly known as the Delaware business trust act). Torch conveyed the Net Profits Interests to the Trust in exchange for an aggregate of 8,600,000 units of beneficial interest ( Units ). Such Units were sold to the public through various underwriters in November 1993. The current working interest owners of the Underlying Properties are TRC, Torch E&P Company and Samson Lone Star Limited Partnership ( Working Interest Owners ). .

Certain information and footnote disclosures normally included in the annual financial statements have been omitted pursuant to such rules and regulations, although the Trustee believes that the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the December 31, 2012 financial statements and notes thereto included in the Trust s applicable annual report on Form 10-K. All adjustments necessary to present fairly the assets, liabilities and trust corpus of the Trust as of September 30, 2013 and December 31, 2012, the distributable income (loss) and changes in trust corpus for the three-month and nine-month periods ended September 30, 2013 and 2012 have been included. All such adjustments are of a normal recurring nature. The distributable income (loss) for such interim periods is not necessarily indicative of the distributable income (loss) for the full year.

**TORCH ENERGY ROYALTY TRUST**

The sole purpose of the Trust is to hold the Net Profits Interests, to receive payments from the Working Interest Owners, and to make payments to Unitholders. The Trust does not conduct any business activity and has no officers, directors or employees. The Trust and Trustee rely on third party service providers to perform administrative services for the Trust. Torch currently provides via a letter agreement the administrative services historically provided by Torch to the Trust through December 31, 2013 consistent with past practice and (ii) from December 31, 2013 to April 30, 2014 shall provide services to the Trust in support of any tax correspondence (tax booklet) and tax filings that might be necessary for the year ended December 31, 2013 consistent with past practice and other related services necessary to complete the wind down of the Trust that are also consistent with past practice. Subsequently, the inability of the Trust to hire qualified services providers to assist in the wind down and liquidation of the Trust may have a material adverse effect on the operations of the Trust.

The Trust has no officers, directors or employees. The Trust and Trustee rely solely on receiving accurate information, reports and other representations from Torch and other service providers to the Trust. In executing and submitting this report on behalf of the Trust and with respect to David A. Vanaskey in executing the certifications relating to this report, the Trustee and David A. Vanaskey have relied upon the accuracy of such reports, information and representations.

**TORCH ENERGY ROYALTY TRUST**

**STATEMENTS OF ASSETS, LIABILITIES AND TRUST CORPUS**

(In thousands)

**ASSETS**

	September 30, 2013 (Unaudited)	December 31, 2012
Cash	\$ 3,724	\$ 1,139
Net profits interests in oil and natural gas properties (Net of accumulated amortization of \$180,600 and \$177,259 at September 30, 2013 and December 31, 2012, respectively)		3,341
	\$ 3,724	\$ 4,480

**LIABILITIES AND TRUST CORPUS**

Trust expense payable	\$ 403	\$ 290
Trust corpus	3,321	4,190
	\$ 3,724	\$ 4,480

See notes to financial statements

**TORCH ENERGY ROYALTY TRUST**

**STATEMENTS OF DISTRIBUTABLE INCOME (LOSS)**

(In thousands, except per Unit amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net profits income	\$	\$	\$	\$
Infill well proceeds	22	25	83	109
Net profits interests sales proceeds	3,258		3,258	
	3,280	25	3,341	109
General and administrative expenses	384	254	869	928
Distributable income \ (loss)	\$ 2,896	\$ (229)	\$ 2,472	\$ (819)
Distributable income \ (loss) per Unit (8,600 Units)	\$ 0.34	\$ (0.03)	\$ 0.29	\$ (0.10)
Distributions per Unit	\$	\$	\$	\$

See notes to financial statements

**TORCH ENERGY ROYALTY TRUST**

**STATEMENT OF CHANGES IN TRUST CORPUS**

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Trust corpus, beginning of period	\$ 3,705	\$ 4,716	\$ 4,190	\$ 5,390
Amortization of Net Profits Interests	(22)	(25)	(83)	(109)
Basis of net profits interests sold	(3,258)		(3,258)	
Distributable income \ (loss)	2,896	(229)	2,472	(819)
Distributions to Unitholders				
Trust corpus, end of period	\$ 3,321	\$ 4,462	\$ 3,321	\$ 4,462

See notes to financial statements

## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

#### **1. Nature of Operations**

The Torch Energy Royalty Trust ( Trust ) was formed effective October 1, 1993, pursuant to a trust agreement ( Trust Agreement ) among Wilmington Trust Company, not in its individual capacity but solely as trustee of the Trust ( Trustee ), Torch Royalty Company ( TRC ) and Velasco Gas Company, Ltd. ( Velasco ) as owners of certain oil and natural gas properties ( Underlying Properties ) and Torch Energy Advisors Incorporated ( Torch ) as grantor. The Trust was formed under the Delaware statutory trust act (formerly known as the Delaware business trust act). TRC and Velasco created net profits interests ( Net Profits Interests ) which burden the Underlying Properties and conveyed such interests to Torch. Torch conveyed the Net Profits Interests to the Trust in exchange for an aggregate of 8,600,000 units of beneficial interest ( Units ). Such Units were sold to the public through various underwriters in November 1993. The current working interest owners of the Underlying Properties are Torch Royalty Company, Torch E&P Company and Samson Lone Star Limited ( Working Interest Owners ). .

The Net Profits Interests entitle the Trust to receive 95% of the Net Proceeds attributable to oil and gas produced and sold from wells (other than infill wells) on the Underlying Properties. The Net Profits Interests also entitle the Trust to 20% of the Net Proceeds of wells drilled on the Underlying Properties since the Trust's establishment into formations in which the Trust has an interest, other than wells drilled to replace damaged or destroyed wells ( Infill Wells ).

The Underlying Properties constitute working interests in the Chalkley Field in Louisiana ( Chalkley Field ), the Robinson's Bend Field in the Black Warrior Basin in Alabama ( Robinson's Bend Field ), fields that produce from the Cotton Valley formations in Texas ( Cotton Valley Fields ) and fields that produce from the Austin Chalk formation in Texas ( Austin Chalk Fields ). The Underlying Properties represent interests in all productive formations from 100 feet below the deepest productive formation in each field to the surface when the Trust was formed. The Trust therefore has no interest in deeper productive formations.

The Trust has no officers, directors or employees. The Trust and Trustee rely solely on receiving accurate information, reports and other representations from Torch and other service providers to the Trust. In executing and submitting this report on behalf of the Trust and with respect to David A. Vanaskey in executing the certifications relating to this report, the Trustee and David A. Vanaskey have relied upon the accuracy of such reports, information and representations.



## TORCH ENERGY ROYALTY TRUST

### Notes to Financial Statements

The Trust received the affirmative vote of the Unitholders of more than 66 2/3% of the outstanding Units to terminate the Trust at the meeting of Unitholders held on January 29, 2008 (the Termination Date ). Upon termination of the Trust, among other things, the Trustee is required to sell the Net Profits Interests. Specifically, pursuant to Section 9.03(e) of the Trust Agreement if the property of the Trust Estate (as defined in the Trust Agreement) has not been sold prior to the end of one calendar year following the termination date, the Trustee, thereafter, must cause such assets to be sold at public auction. See Note 5 for additional information concerning the liquidation of the Trust's Net Profits Interests.

The sole purpose of the Trust is to hold the Net Profits Interests, to receive payments from TRC and Velasco, and to make payments to Unitholders. The Trust does not conduct any business activity. The Trust has sold all of the Net Profits Interests and is winding down operations.

TRC and Velasco receive payments reflecting the proceeds of oil and natural gas sold and aggregate these payments, deduct applicable costs and make payments to the Trustee each quarter for the amounts due to the Trust. Prior to the Trust's termination on January 29, 2008, Unitholders received quarterly cash distributions relating to oil and natural gas produced and sold from the Underlying Properties. Pursuant to Section 3.07 of the Trust Agreement, the Trustee established a cash reserve ( Cash Reserve ) in 2008 following the Trust's termination. See Note 4 for additional information regarding cash distributions and the Cash Reserve. Because no additional properties will be contributed to the Trust, the assets of the Trust deplete over time and a portion of each cash distribution made by the Trust is analogous to a return of capital.

The only assets of the Trust, other than cash and temporary investments being held for the payment of actual, contingent and uncertain liabilities and for distribution to Unitholders, are the Net Profits Interests. Under the Trust Agreement, the Trustee receives the payments attributable to the Net Profits Interests and pays all expenses, liabilities and obligations of the Trust. The Trustee has the discretion to establish a cash reserve for the payment of any liability that is contingent or uncertain in amount or that otherwise is not currently due and payable. The Trustee is entitled to cause the Trust to borrow money to pay expenses, liabilities and obligations that cannot be paid out of cash held by the Trust. The Trustee is entitled to cause the Trust to borrow from any source, including from the entity serving as Trustee, provided that the entity serving as Trustee shall not be obligated to lend to the Trust. To secure payment of any such indebtedness (including any indebtedness to the Trustee), the Trustee is authorized to (i) mortgage and otherwise encumber the entire Trust estate or any portion thereof; (ii) carve out and convey production payments; (iii) include all terms, powers, remedies, covenants and provisions it deems necessary or advisable, including confession of judgment and the power of sale with or without judicial proceedings; and (iv) provide for the exercise of those and other remedies available to a secured lender in the event of a default on such loan. The terms of such indebtedness and security interest, if funds were loaned by the Trustee, must be similar to the terms which the Trustee would grant to a similarly situated commercial customer with whom it did not have a fiduciary relationship, and the Trustee shall be entitled to enforce its rights with respect to any such indebtedness and security interest as if it were not then serving as Trustee.

On January 24, 2013, the Trust received notice from NYSE Regulation, Inc. ( NYSE Regulation ) informing the Trust that NYSE Regulation has determined to commence proceedings to delist the Trust's units from the New York Stock Exchange ( NYSE ), with trading of the units to be suspended prior to the opening of NYSE trading on January 30, 2013.



## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

NYSE Regulation informed the Trust that the delisting determination was based on the Trust's delay in filing its Annual Report for the year ended December 31, 2011 on Form 10-K and subsequent Quarterly Reports for the fiscal quarters ending in 2012 with the Securities and Exchange Commission. The Trust had previously utilized the six-month cure period under Section 802.01C of the NYSE Listed Company Manual and a subsequent three-month extension of the filing date for the Annual Report to January 16, 2013 from NYSE Regulation, the Trust was unable to file the Annual Report by this extended deadline. NYSE Regulation declined the Trust's request for further extension under Section 802.01C of the NYSE Listed Company Manual of the filing deadline. NYSE Regulation also noted that the average closing price of the Trust's units had previously fallen below the NYSE's continued listing minimum share price standard (Section 802.01E of the NYSE Listed Company Manual) of \$1.00 over a consecutive 30 trading day period. Trading of the Units was suspended prior to the opening of NYSE trading on Wednesday, January 30, 2013. The Trust commenced trading on the Pink Sheets on that same day, under the symbol "TRRU".

The Trustee is authorized and directed to sell and convey the Net Profits Interests without Unitholder approval in certain instances as described in the Trust Agreement, including upon termination of the Trust. The Trustee is empowered by the Trust Agreement to employ consultants, legal and financial advisors and agents (including Torch) and to make payments of all fees for services or expenses out of the assets of the Trust.

#### **2. Basis of Accounting, Significant Accounting Policies**

The financial statements of the Trust are prepared on a modified cash basis and are not intended to present the financial position and results of operations in conformity with generally accepted accounting principles generally accepted in the United States of America ("GAAP"). Preparation of the Trust's financial statements on such basis includes the following:

Revenues are recognized in the period in which amounts are received by the Trust. Therefore, revenues recognized during the three-month and nine-month periods ended September 30, 2013 and 2012 are derived from oil and natural gas production sold during the three-month and nine-month periods ended June 30, 2013 and 2012, respectively. The Trust did not receive revenues from TRC with respect to production during each of the nine-month periods ended June 30, 2013 and 2012 as a result of TRC recouping overpayments made to the Trust in 1994 and 1995 with respect to the Chalkley Field (the "Chalkley Gas Volume Adjustment"). See Note 4 for additional information regarding this adjustment.

General and administrative expenses are recognized on an accrual basis.

Amortization of the Net Profits Interests is calculated on a unit-of-production basis and charged directly to trust corpus.

Distributions to Unitholders are recorded when declared by the Trustee.



## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

The Trust reviews the Net Profits Interests for impairment whenever events or changes in circumstances indicate the carrying amount of the Net Profits Interests may not be recoverable. Recoverability is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the Net Profits Interests. If such asset is considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds either the fair value or the estimated discounted cash flows of the assets, whichever is more readily measurable. At September 30, 2013 and 2012, no impairment was deemed necessary.

The financial statements of the Trust differ from financial statements prepared in accordance with GAAP because net profits income is not accrued in the period of production and amortization of the Net Profits Interests is not charged against operating results.

#### **3. Federal Income Taxes and Texas State Margin Tax**

Tax counsel has advised the Trust and Trustee that, under current tax law, the Trust is classified as a grantor trust for federal income tax purposes and not an association taxable as a business entity. However, the opinion of tax counsel is not binding on the Internal Revenue Service. As a grantor trust, the Trust is not subject to federal income tax.

Because the Trust is treated as a grantor trust for federal income tax purposes and a Unitholder is treated as directly owning an interest in the Net Profits Interests, each Unitholder is taxed directly on such Unitholder's pro rata share of income attributable to the Net Profits Interests consistent with the Unitholder's method of accounting and without regard to the taxable year or accounting method employed by the Trust. Amounts payable with respect to the Net Profits Interests are paid to the Trust on the quarterly record date established for quarterly distributions in respect to each calendar quarter during the term of the Trust, and the income and deductions from such payments are allocated to the Unitholders of record on such date.

In May 2006, the State of Texas passed legislation to implement a margin tax at a rate of 1% to be imposed generally on federal gross revenues (up to 70%), as apportioned to Texas less certain costs and deductions, as specifically set forth in the new legislation. The effective date of the legislation was January 1, 2008, but the tax was generally imposed on revenues generated in 2007 and thereafter (earlier for certain fiscal year taxpayers). Entities subject to tax generally include trusts unless otherwise exempt and most other types of entities having limited liability protection. Trusts that meet certain statutory requirements are generally exempt from the margin tax as passive entities.

Since the Trust is exempt from the margin tax at the Trust level as a passive entity, each Unitholder that is a taxable entity would generally include its share of the Trust's revenue in its margin tax computation. This revenue would be sourced to Texas under Texas Comptroller guidance that provides such income is sourced according to the principal place of business of the Trust, which is Texas.

## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

#### **4. Distributions and Income Computations**

Each quarter the amount of cash available for distribution to Unitholders (the Quarterly Distribution Amount) is equal to the excess, if any, of the cash received by the Trust, on the last day of the second month following the previous calendar quarter (or the next business day thereafter) ending prior to the dissolution of the Trust, from the Net Profits Interests then held by the Trust plus, with certain exceptions, any other cash receipts of the Trust during such quarter, subject to adjustments for changes made by the Trustee during such quarter in the Cash Reserve established for the payment of actual, contingent and uncertain liabilities of the Trust. Based on the payment procedures relating to the Net Profits Interests, cash received by the Trust on the last day of the second month of a particular quarter from the Net Profits Interests generally represents proceeds from the sale of oil and natural gas produced from the Underlying Properties during the preceding calendar quarter. The Quarterly Distribution Amount for each quarter is generally payable to Unitholders of record on the last day of the second month of the calendar quarter unless such day is not a business day, in which case the record date is the next business day thereafter. The Trust distributes the Quarterly Distribution Amount within approximately 10 days after the record date to each person who was a Unitholder of record on the associated record date.

During the three-month period ended December 31, 2011, TRC computed the Chalkley Gas Volume Adjustment whereby TRC determined that it had overpaid the Trust \$3.0 million (including \$1.9 million of accrued interest as of December 31, 2011) in 1994 and 1995 with respect to TRC's Underlying Property interests in the Chalkley Field. Neither the Trust nor Unitholders are obligated to return such overpayment to TRC; however, the Trust will receive no Net Proceeds with respect to TRC's interests in the Underlying Properties of the Chalkley Field, the Cotton Valley Fields and the Austin Chalk Fields (TRC Underlying Property Interests) until future Net Proceeds from the TRC Underlying Property Interests, plus accrued interest, exceed the unrecouped balance of such overpayment. The Chalkley Gas Volume Adjustment was settled on August 30, 2013.

On August 30, 2013, the Trust simultaneously signed and closed a Purchase and Sale Agreement (PSA) by and among the Trust, TRC, Torch E&P Company, N.M.L. Inc., of Texas (formerly Torch Energy Services, Inc.), and Torch, pursuant to which the Trust and the Torch Energy Louisiana Royalty Trust sold all of its remaining net profits interests attributable to the underlying working interests in certain fields that produce from the Cotton Valley Fields, Austin Chalk Fields and Chalkley Field for a purchase price of \$3,258,330. Such sales proceeds are classified as net profits interests sales proceeds in the Trust's statements of distributable income (loss). See Note 5 for additional information.

As a result of the Chalkley Gas Volume Adjustment, the Trust received no net profits income during each of the three-month and nine-month periods ended September 30, 2013 as a result of TRC withholding Net Proceeds from the Trust totaling \$0.2 million and \$0.9 million, respectively. During the three-month and nine-month periods ended September 30, 2013, Net Proceeds received from the Trust pertaining to the Infill wells totaled \$22,000 and \$83,000, respectively. Such amounts are classified as Infill Well proceeds in the Trust's statements of distributable income (loss). During each of the three-month and nine-month periods ended September 30, 2013, the Trust made no cash distributions to Unitholders. As of September 30, 2013 and December 31, 2012, the Cash Reserve was \$3.7 million and \$1.1 million, respectively.



## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

As a result of the Chalkley Gas Volume Adjustment, the Trust received no net profits income during each of the three-month and nine-month periods ended September 30, 2012 as a result of TRC withholding Net Proceeds from the Trust totaling \$0.2 million and \$1.1 million, respectively. During the three-month and nine-month periods ended September 30, 2012, the Trust received cash payments totaling \$25,000 and \$109,000, respectively, from the Working Interest Owners of the Underlying Properties which pertain to Net Proceeds generated from the Infill Wells. Such amounts are classified as Infill Well proceeds in the Trust's statements of distributable income (loss) during the three-month and nine-month periods ended September 30, 2012. During each of the three-month and nine-month periods ended September 30, 2012, the Trust made no cash distributions to Unitholders.

#### **5. Termination and Liquidation of the Net Profits Interests**

The Trust received the affirmative vote of the Unitholders of more than 66 2/3% of the outstanding Units to terminate the Trust at the meeting of Unitholders held on January 29, 2008, the Termination Date. Upon termination of the Trust, among other things, the Trustee is required to sell the Net Profits Interests. Specifically, pursuant to Section 9.03(e) of the Trust Agreement if the property of the Trust Estate (as defined in the Trust Agreement) has not been sold prior to the end of one calendar year following the termination date, the Trustee, thereafter, must cause such assets to be sold at public auction.

On August 4, 2011 the Trust entered into a material definitive agreement for advisory and marketing services with an effective date of August 1, 2011 with respect to the sale of the Net Profits Interests pursuant to an agreement with PLS, Inc., a Texas corporation. The Trust notified Robinson's Bend Production II, LLC. ( "RBP II" ), a Delaware limited liability company and a subsidiary of Constellation Energy Partners, on November 3, 2011 that it was the successful bidder in the public auction of the sale of the Net Profits Interests attributable to the Robinson's Bend Field. On December 13, 2011, the Trust entered into a purchase and sale agreement by and between RBP II pursuant to which the Trust agreed to sell, and RBP II agreed to purchase, all of the Trust's Net Profits Interests attributable to the Underlying Properties in the Robinson's Bend Field for a purchase price of \$1,000,000. The sale signed and closed simultaneously on December 13, 2011.

On August 30, 2013, the Trust simultaneously signed and closed a PSA by and among the Trust, TRC, Torch E&P Company, N.M.L. Inc., of Texas (formerly Torch Energy Services, Inc.), and Torch, pursuant to which the Trust and the Torch Energy Louisiana Royalty Trust sold all of its remaining net profits interests attributable to the underlying working interests in certain fields that produce from the Cotton Valley Fields, Austin Chalk Fields and Chalkley Field for a purchase price of \$3,258,330. Pursuant to the PSA, TRC provided the Trust a release, including a release of claims with respect to TRC's unrecouped balance pertaining to the



## TORCH ENERGY ROYALTY TRUST

### Notes to Financial Statements

Chalkley Gas Volume Adjustment. The unrecouped balance of \$0.5 million consisted of the total amount claimed by TRC of \$3.1 million minus net proceeds from the underlying properties withheld by TRC of \$2.6 million. The PSA also provided TRC a release of claims with respect to the Trust Net Proceeds generated from TRC's Underlying Property Interest attributable to oil and gas sales. The PSA also contains customary representations, warranties and covenants. The Trust no longer receives any proceeds from the Net Profits Interests for the Cotton Valley Fields, Austin Chalk Fields and the Chalkley Field as of May 1, 2013, the effective date of the PSA.

The Trustee anticipates it will continue to consult with the Trust's and Trustee's financial and legal advisors in the wind down of the Trust.

#### 6. Related Party Transactions

TRC and Velasco contracted to sell the oil and natural gas production from the Underlying Properties to Torch Energy Marketing, Inc. ( TEMI ), a subsidiary of Torch, under a purchase contract ( Purchase Contract ). Upon termination of the Trust, the Purchase Contract expired and the Working Interest Owners calculate the Net Proceeds owed to the Trust utilizing the same pricing mechanisms (including the sharing price and minimum price commitment mechanisms) as the expired Purchase Contract.

#### *Marketing Arrangements and Price Sharing*

In connection with the formation of the Trust, TRC, Velasco and TEMI entered into the Purchase Contract which expired upon termination of the Trust. Pursuant to the Purchase Contract, TEMI was obligated to purchase all net production attributable to the Underlying Properties for an index price for oil and natural gas ( Index Price ), less certain gathering, treating and transportation charges, which were calculated monthly. The Index Price equals 97% of the weighted average spot market prices of oil and natural gas ( Average Market Prices ) at the four locations where TEMI sold production.

The Purchase Contract also provided that TEMI pay a minimum price ( Minimum Price ) for natural gas production, adjusted annually for inflation. When TEMI paid a purchase price based on the Minimum Price it received price credits ( Price Credits ), equal to the difference between the Index Price and the Minimum Price, that it was entitled to deduct in determining the purchase price when the Index Price for natural gas exceeded the Minimum Price. In addition, if the Index Price for natural gas exceeded the sharing price, which was adjusted annually for inflation ( Sharing Price ), TEMI was entitled to deduct 50% of such excess ( Price Differential ) in determining the purchase price. TEMI had an annual option to discontinue the Minimum Price commitment. However, if TEMI discontinued the Minimum Price commitment, it would no longer be entitled to deduct the Price Differential in calculating the purchase price and would have forfeited all accrued Price Credits. As of the Termination Date, TEMI had no outstanding Price Credits and had not exercised its option to discontinue the Minimum Price commitment.

## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

Upon the Trust's termination, pursuant to each Conveyance, the Working Interest Owners utilized the same pricing mechanisms (including the Sharing Price and Minimum Price commitment mechanisms) as the expired Purchase Contract in calculating Net Proceeds due to the Trust. The Minimum Price per MMBtu was \$2.10, \$2.05 and \$1.99 for 2013, 2012 and 2011 natural gas sales, respectively. The Sharing Price per MMBtu was \$2.59, \$2.54 and \$2.46 for 2013, 2012 and 2011 natural gas sales, respectively. Pursuant to each Conveyance, the Working Interest Owners also have the same annual option to discontinue the Minimum Price commitment. As a result of the Sharing Price arrangement, Net Proceeds attributable to the Underlying Properties during the three-month period ended September 30, 2013 were reduced by \$0.1 million. The Sharing Price arrangement did not reduce Net Proceeds attributable to the Underlying Properties during the three-month period ended September 30, 2012. As a result of the Sharing Price arrangement, Net Proceeds attributable to the Underlying Properties during the nine-month periods ended September 30, 2013 and 2012 were reduced by \$0.3 million and \$0.1 million, respectively. As of September 30, 2013, the Working Interest Owners had no outstanding Price Credits and had not exercised its right to discontinue the Minimum Price commitment.

Under each Conveyance, natural gas volumes are determined at the wellhead. Therefore, Net Proceeds do not include any amounts received in connection with extracting natural gas liquids from such production at natural gas processing or treating facilities.

#### *Gathering, Treating and Transportation Arrangements*

The Purchase Contract, which expired upon the Trust's termination, entitled TEMI to deduct certain natural gas gathering, treating and transportation fees in calculating the purchase price for natural gas in the Robinson's Bend, Austin Chalk and Cotton Valley Fields. The amounts that were deducted in calculating the purchase price for such natural gas were set forth in the Purchase Contract and were not affected by the actual costs incurred by TEMI to gather, treat and transport natural gas. Upon the Trust's termination, pursuant to each Conveyance, the Working Interest Owners became entitled to deduct the same natural gas gathering, treating and transportation fees that had previously been deducted by TEMI pursuant to the Purchase Contract in calculating Net Proceeds due to the Trust.

In computing Net Proceeds due to the Trust for the Austin Chalk Fields, \$0.38 per MMBtu plus 17% of revenues are deducted as a fee to gather, treat and transport natural gas production. TEMI deducted from the purchase price for natural gas for production attributable to certain wells in the Cotton Valley Fields a transportation fee of \$0.045 per MMBtu. During the three-month periods ended September 30, 2013 and 2012, such fees deducted from the Net Proceeds calculations attributable to production during the three-month periods ended June 30, 2013 and 2012 in the Austin Chalk and Cotton Valley Fields totaled \$0.01 million and \$0.02 million, respectively. During each of the nine-month periods ended September 30, 2013 and 2012, such fees deducted from the Net Proceeds calculations, attributable to production during the nine-month periods ended June 30, 2013 and 2012 in the Austin Chalk and Cotton Valley Fields totaled \$0.05 million and \$0.07 million, respectively. No amounts for gathering, treating or transportation are deducted in calculating the purchase price from the Chalkley Field.

## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

#### *Administrative Services Agreement*

Torch provided accounting, bookkeeping, informational and other services to the Trust related to the Net Profits Interests pursuant to the Administrative Services Agreement effective October 1, 1993 and an oral arrangement after termination of the Administrative Services Agreement on January 29, 2008 through April 1, 2008. On November 7, 2008, an agreement was entered into between the Trust and Torch that engaged Torch to provide certain accounting services in connection with the Trust's preparation and filing of the Trust's Form 10-K for the year ended December 31, 2007.

To facilitate the winding down of the Trust, Torch currently provides certain accounting and other services for the Trust pursuant to an agreement with the Trust entered into on March 26, 2009. The initial term of the agreement expired on March 31, 2010 and was thereafter extended from year to year, up to the period ending August 30, 2013. Torch currently provides the Trust via letter agreement the administrative services historically provided by Torch to the Trust through December 31, 2013 consistent with past practice and (ii) from December 31, 2013 to April 30, 2014 shall provide services to the Trust in support of any tax correspondence (tax booklet) and tax filings that might be necessary for the year ended December 31, 2013 consistent with past practice and other related services necessary to complete the wind down of the Trust that are also consistent with past practice. Subsequently, the inability of the Trust to hire qualified service providers to assist in the wind down and liquidation of the Trust may have a material adverse effect on the operations of the Trust.

Services fees charged to the Trust by Torch during each of the three-month periods ended September 30, 2013 and 2012 were \$0.1 million. Services fees during each of the nine-month periods ended September 30, 2013 and 2012 were \$0.3 million.

#### *Operator Overhead Fees*

A subsidiary of Torch operates certain oil and natural gas interests burdened by the Net Profits Interests. The Underlying Properties are charged, on the same basis as other third parties, for all customary expenses and costs reimbursements associated with these activities. Operator overhead fees deducted from the Net Proceeds computations for the Chalkley, Cotton Valley and Austin Chalk Fields totaled \$62,000 and \$60,000 during the three-month periods ended September 30, 2013 and 2012, respectively. Operator overhead fees deducted from the Net Proceeds computations for the Chalkley, Cotton Valley and Austin Chalk Fields totaled \$182,000 and \$172,000 during the nine-month period ended September 30, 2013 and 2012, respectively.

#### *Compensation of the Trustee and Transfer Agent*

The Trust Agreement provides that the Trustee be compensated for its administrative services, out of the Trust assets, in an annual amount of \$80,000, plus an hourly charge for services in excess of a combined total of 250 hours annually at its standard rates. In accordance with provisions in the Trust Agreement, the Trustee may increase its compensation for its administrative services as a result of unusual or extraordinary services rendered by the Trustee.

## **TORCH ENERGY ROYALTY TRUST**

### **Notes to Financial Statements**

Additionally, the Trustee receives a transfer agency fee of \$5.00 annually per account (minimum of \$15,000 annually), subject to change each December, beginning December 1994, based upon the change in the Producer's Price Index as published by the Department of Labor, Bureau of Labor Statistics, plus \$1.00 for each certificate issued.

Total administrative and transfer agent fees charged by the Trustee for services performed during each of the three-month periods ended September 30, 2013 and 2012 were \$25,000. Total administrative and transfer agent fees charged by the Trustee for services performed during the nine-month periods ended September 30, 2013 and 2012 were \$91,000 and \$75,000, respectively.

#### **7. Trust Expense Payable**

The Trust expense payable at September 30, 2013 and December 31, 2012 was \$403,000 and \$290,000, respectively. Such liability mainly represents general and administrative expense accruals mainly pertaining to the Trust's legal fees, accounting and audit fees, and administrative services fees.

#### **8. Subsequent Events**

On December 4, 2013, the Trust announced a cash distribution of \$3,390,639 or 39.426 cents per unit, payable on December 23, 2013 to Unitholders of record on December 13, 2013. On December 13, 2013, the Trust announced that the cash distribution which was announced on December 4, 2013 was adjusted downward by \$360,000 due to additional expenses forecasted in the wind down and liquidation of the Trust. As a result, the previously announced applicable record date and the distribution date were adjusted accordingly. The revised distribution is \$3,031,349 or 35.25 cents per Unit, payable on December 30, 2013 to Unitholders of record on December 23, 2013. This distribution mainly relates to the proceeds from the PSA. Immediately following the December 13, 2013 announcement, the Trust's Cash Reserve, net of the \$3,031,349 cash distribution payable on December 30, 2013, was approximately \$510,000. To the extent that any of the Cash Reserve remains after the payment of all of the Trust's expenses, the Trustee may make one or more additional cash distributions to the Unitholders of record; however, no assurance can be made that any such distributions will occur.

## TORCH ENERGY ROYALTY TRUST

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

#### Results of Operations

Because a modified cash basis of accounting is utilized by the Trust, Net Proceeds attributable to the Underlying Properties for the three-month periods ended September 30, 2013 and 2012 is derived from actual oil and natural gas produced during the three-month periods ended June 30, 2013 and 2012, respectively. Net Proceeds attributable to the Underlying Properties for the nine-month periods ended September 30, 2013 and 2012 is derived from actual oil and natural gas produced during the nine-month periods ended June 30, 2013 and 2012, respectively.

The data set forth in the table below excludes the effect of the Chalkley Gas Volume Adjustment. See Note 4 of the Trust's accompanying financial statements for additional information concerning this adjustment.

	Three Months Ended September 30, 2013 (a)		2012 (a)	
	Bbls of Oil	Mcf of Natural Gas	Bbls of Oil	Mcf of Natural Gas
Chalkley Field	390	94,526	333	110,402
Cotton Valley Fields	52	84,181	157	94,645
Austin Chalk Fields	675	8,995	997	16,233
	1,117	187,702	1,487	221,280

  

	Nine Months Ended September 30, 2013 (a)		2012 (a)	
	Bbls of Oil	Mcf of Natural Gas	Bbls of Oil	Mcf of Natural gas
Chalkley Field	1,148	301,503	1,219	346,645
Cotton Valley Fields	355	268,199	875	291,436
Austin Chalk Fields	2,199	32,018	3,266	56,069
	3,702	601,720	5,360	694,150

- (a) Excludes the effect of the Chalkley Gas Volume Adjustment which reduced Net Proceeds paid to the Trust during each of the three-month and nine-month periods ended September 30, 2013 and 2012 by \$0.2 million and \$0.9 million, respectively. The Chalkley Gas Volume Adjustment reduced Net Proceeds paid to the Trust during the three-month and nine-month periods ended September 30, 2012 by \$0.2 million and \$1.1 million, respectively.

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**TORCH ENERGY ROYALTY TRUST**

**Three Months Ended September 30, 2013 Compared to Three Months Ended September 30, 2012**

The Trust received no net profits income from the Trust during each of the three-month periods ended September 30, 2013 and 2012 as a result of the Chalkley Gas Volume Adjustment which recouped overpayments made to the Trust by TRC in 1994 and 1995. Neither the Trust nor Unitholders are obligated to return such overpayment to TRC; however, the Trust will receive no Net Proceeds with respect to TRC's interests in the Underlying Properties of the Chalkley Field, the Cotton Valley Fields and the Austin Chalk Fields ( TRC Underlying Property Interests ) until future Net Proceeds from the TRC Underlying Property Interests, plus accrued interest, exceed the unrecouped balance of such overpayment. During each of the three-month periods ended September 30, 2013 and 2012, TRC withheld Net Proceeds from the Trust totaling \$0.2 million. As of September 30, 2013, the unrecouped balance of the Chalkley Gas Volume Adjustment was \$0.5 million. See Note 4 of the Trust's accompanying financial statements for additional information concerning this adjustment.

Prior to the effect of the Chalkley Gas Volume Adjustment, natural gas production attributable to the Underlying Properties in the Chalkley, Cotton Valley and Austin Chalk Fields (excluding production generated from the Infill Wells) was 187,702 Mcf and 221,280 Mcf during the three-month periods ended September 30, 2013 and 2012, respectively. Oil production attributable to the Underlying Properties for the three-month periods ended September 30, 2013 and 2012 was 1,117 Bbls and 1,487 Bbls, respectively. Oil production decreased during 2013 as a result of normal production declines.

During the three-month period ended September 30, 2013, the average price used to calculate Net Proceeds for natural gas, before gathering, treating and transportation deductions, was \$3.14 per MMBtu as compared to \$2.01 per MMBtu for the three-month period ended September 30, 2012. During the three-month period ended September 30, 2013, the average price used to calculate Net Proceeds for oil was \$86.43 per Bbl as compared to \$86.34 per Bbl for the three-month period ended September 30, 2012. Such average price calculations exclude the impact of the Chalkley Gas Volume Adjustment discussed in Note 4 of the Trust accompanying financial statements.

Prior to the Trust's termination on January 29, 2008, TEMI deducted the Price Differential and was committed to pay a Minimum Price for natural gas. When TEMI paid a purchase price for natural gas based on the Minimum Price, TEMI received Price Credits which it was entitled to deduct in determining the purchase price when the Index Price for natural gas exceeded the Minimum Price. TEMI had not exercised its right to discontinue the Minimum Price commitment and had no outstanding Price Credits on the Termination Date. Additionally, if the Index Price for natural gas exceeded \$2.10 per MMBtu, adjusted annually for inflation, TEMI deducted 50% of such excess in calculating the Net Proceeds payable to the Trust.

Upon the Trust's termination, pursuant to each Conveyance, the Working Interest Owners used the same pricing mechanisms as the expired Purchase Contract (including the Sharing Price and Minimum Price commitment mechanisms) in calculating Net Proceeds due to the Trust. The Minimum Price per MMBtu was \$2.10, \$2.05 and \$1.99 for 2013, 2012 and 2011 production, respectively. The Sharing Price per MMBtu was \$2.59, \$2.54 and \$2.46 for 2013,

## **TORCH ENERGY ROYALTY TRUST**

2012 and 2011 production, respectively. Pursuant to each Conveyance, the Working Interest Owners also have the same annual option to discontinue the Minimum Price commitment. As of September 30, 2013 and December 31, 2012, the Working Interest Owners had no outstanding Price Credits and had not exercised their right to discontinue the Minimum Price commitment. Price Credits totaling \$8,000 were deducted in calculating the purchase price related to net profits income during the three-month period ended September 30, 2012. All such Price Credits were recouped by the Working Interest Owners in the same period. No Price Credits were deducted in calculating the purchase price related to net profits income during the three-month period ended September 30, 2013. The deduction of the Price Differential in connection with the Sharing Price mechanism reduced Net Proceeds paid to the Trust during the three-month period ended September 30, 2013 by \$0.1 million. The Sharing Price mechanism did not impact the Net Proceeds calculation during the three-month period ended September 30, 2012.

During the three-month periods ended September 30, 2013 and 2012, the Trust recognized \$22,000 and \$25,000 of Infill Well income with respect to the Cotton Valley Fields Infill Wells. Such Infill Wells are operated by Samson Lone Star Limited Partnership.

Prior to the effect of the Chalkley Gas Volume Adjustment, lease operating expenses and capital expenditures attributable to the Underlying Properties in the Chalkley, Cotton Valley and Austin Chalk Fields deducted in calculating Net Proceeds due to the Trust for the three-month periods ended September 30, 2013 and 2012 totaled \$0.4 million and \$0.3 million, respectively.

General and administrative expenses amounted to \$0.4 million and \$0.3 million, respectively, for each of the three-month periods ended September 30, 2013 and 2012. Such general and administrative expenses include costs pertaining to the administrative services provided by Torch and the Trustee, legal fees, accounting and audit fees, reserve report preparation fees, and Unitholder report printing fees.

On August 30, 2013, the Trust simultaneously signed and closed a Purchase and Sale Agreement ( PSA ) by and among the Trust, TRC, Torch E&P Company, N.M.L. Inc., of Texas (formerly Torch Energy Services, Inc.), and Torch, pursuant to which the Trust and the Torch Energy Louisiana Royalty Trust sold all of its remaining net profits interests attributable to the underlying working interests in certain fields that produce from the Cotton Valley Fields, Austin Chalk Fields and Chalkley Field for a purchase price of \$3,258,330. Pursuant to the PSA, TRC provided the Trust a release, including a release of claims with respect to TRC's unrecouped balance pertaining to the Chalkley Gas Volume Adjustment. The unrecouped balance of \$0.5 million consisted of the total amount claimed by TRC of \$3.1 million minus net proceeds from the underlying properties withheld by TRC of \$2.6 million. The PSA also provided TRC a release of claims with respect to the Trust Net Proceeds generated from TRC's Underlying Property Interest attributable to oil and gas sales. The PSA also contains customary representations, warranties and covenants. The Trust no longer receives any proceeds from the Net Profits Interests for the Cotton Valley Fields, Austin Chalk Fields and the Chalkley Field as of May 1, 2013, the effective date of the PSA.

## **TORCH ENERGY ROYALTY TRUST**

Pursuant to the Trust Agreement, the Trustee established a cash reserve ( Cash Reserve ) following the Trust's termination in 2008 for the payment of actual, contingent and uncertain liabilities associated with the liquidation and winding down of the Trust and the Trust's arbitration. During the three-month periods ended September 30, 2013 and 2012, the Trust received cash payments totaling \$22,000 and \$25,000 respectively, from the Working Interest Owners of the Underlying Properties pertaining to Net Proceeds from the Infill Wells. All such receipts were allocated to the Trust's Cash Reserve. Additionally, the Net Proceeds received from the Trust in connection with the PSA, or \$3.3 million, were allocated to the Cash Reserve. The Cash Reserve as of September 30, 2013 and December 31, 2012 was \$3.7 million and \$1.1 million, respectively.

The foregoing resulted in distributable income of \$2.9 million, or \$0.34 per Unit, for the three-month period ended September 30, 2013 income as compared to a distributable loss of \$0.2 million, or \$0.03 per Unit, for the same period in 2012. During each of the three-month periods ended September 30, 2013 and 2012, the Trust made no cash distributions to Unitholders.

### **Nine Months Ended September 30, 2013 Compared to Nine Months Ended September 30, 2012**

The Trust received no net profits income from the Trust during each of the nine-month periods ended September 30, 2013 and 2012 as a result of the Chalkley Gas Volume Adjustment which recouped overpayments made to the Trust by TRC in 1994 and 1995. Neither the Trust nor Unitholders are obligated to return such overpayment to TRC; however, the Trust will receive no Net Proceeds with respect to TRC's interests in the TRC Underlying Property Interests until future Net Proceeds from the TRC Underlying Property Interests, plus accrued interest, exceed the unrecouped balance of such overpayment. During the nine-month periods ended September 30, 2013 and 2012, TRC withheld Net Proceeds from the Trust totaling \$0.9 million and \$1.1 million, respectively. As of September 30, 2013, the unrecouped balance of the Chalkley Gas Volume Adjustment was \$0.5 million. See Note 4 of the accompanying financial statements for additional information for additional information concerning this adjustment.

Prior to the effect of the Chalkley Gas Volume Adjustment, natural gas production attributable to the Underlying Properties in the Chalkley, Cotton Valley and Austin Chalk Fields (excluding production generated from the Infill Wells) was 601,720 Mcf and 694,150 Mcf during the nine-month period ended June 30, 2013 and 2012, respectively. Oil production attributable to the Underlying Properties during the nine-month period ended September 30, 2013 and 2012 was 3,702 Bbls and 5,360 Bbls, respectively. Oil production decreased during 2013 as a result of normal production declines.

During the nine-month period ended September 30, 2013, the average price used to calculate Net Proceeds for natural gas, before gathering, treating and transportation deductions, was \$2.89 per MMBtu as compared to \$2.42 per MMBtu for the nine-month period ended September 30, 2012. During the nine-month period ended September 30, 2013, the average price used to calculate Net Proceeds for oil was \$85.75 per Bbl as compared to \$89.63 per Bbl for the nine-month period ended September 30, 2012. Such average price calculations exclude the impact of the Chalkley Gas Volume Adjustment discussed in Notes 4 of the Trust accompanying financial statements.



**TORCH ENERGY ROYALTY TRUST**

Prior to the Trust's termination on January 29, 2008, TEMI deducted the Price Differential and was committed to pay a Minimum Price for natural gas. When TEMI paid a purchase price for natural gas based on the Minimum Price, TEMI received Price Credits which it was entitled to deduct in determining the purchase price when the Index Price for natural gas exceeded the Minimum Price. TEMI had not exercised its right to discontinue the Minimum Price commitment and had no outstanding Price Credits on the Termination Date. Additionally, if the Index Price for natural gas exceeded \$2.10 per MMBtu, adjusted annually for inflation, TEMI deducted 50% of such excess in calculating the Net Proceeds payable to the Trust.

Upon the Trust's terminati